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November
2017

Articles

Key changes in 2017 FDI Policy for single brand retail trading sector

By **Anurag Pareek**

Background

Foreign Direct Investment ("FDI") upto 100 percent is allowed in single brand retail trade ("SBRT") sector. FDI upto 49 percent is allowed under the automatic route and FDI in excess of 49 percent requires prior government approval. In addition, FDI in SBRT sector requires compliance with several other conditions. For instance, the products are required to be of a single brand only and sold under the same brand name internationally. Furthermore, companies engaged in SBRT sector with more than 51 percent FDI are required to locally source at least 30 percent of the value of the goods purchased by them (the "SBRT FDI Norms").

An Indian manufacturer is permitted to sell its own brand's products manufactured by them in India in any manner without restrictions regardless of whether it is through wholesale, retail or through e-commerce platforms without complying with the SBRT FDI Norms. However, for an entity to qualify as an Indian manufacturer under the 2016 FDI Policy, it had to manufacture in terms of value, at least 70% of its products in-house and source at most, the remaining 30% from other Indian manufacturers (the "70-30 Rule"). Unfortunately, this 70-30 Rule was not favourable for many Indian manufacturers since this condition implied exclusion of contract manufacturing. This was particularly troublesome for entities without sophisticated manufacturing capabilities and that took recourse to contract manufacturing.

The 2017 FDI Policy made some changes in relation to SBRT FDI Norms. The objective of this article is to analyse the potential impact of such changes. In particular, special emphasis will be given to analyse the issue whether an entity that engages in retail trade of products manufactured by third party contract manufacturers, will be considered to be falling under the SBRT sector or manufacturing sector for the purpose of determining the applicability of the SBRT FDI Norms to such entity.

Key Changes in 2017 FDI Policy

Committee for Examining Applications for Exemption from 30% Local Sourcing Norms

The 2017 FDI Policy provides for 3 years maximum exemption limit from the 30% local sourcing norms for SBRT of products with 'state-of-art' and 'cutting edge' technology where local sourcing is not possible. A committee under the chairmanship of Secretary, DIPP, with representatives of NITI Aayog, concerned administrative ministry and independent technical expert(s) on the subject will examine the claim of applicants on the issue of the products being in the nature of 'state of the art' and 'cutting edge' technology where local sourcing is not possible and give recommendation for relaxation from the local sourcing norms. This is a prudent move as it will effectively streamline the application process for such products and ensure that such applications are evaluated by trained & capable personnel.

The 2017 FDI Policy, however, does not provide for any guidelines or criteria for the committee to determine whether a product is 'state of the art' and possesses 'cutting edge' technology. It

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would be welcome if government publicly provides for some broad guidelines or criteria which would be an aid to prospective applicants seeking exemption from the local sourcing norms.

Relaxation for Indian Manufacturers from the 70-30 Rule

The 2017 FDI Policy deleted the wordings of the 70-30 Rule that existed under the 2016 FDI Policy. Many industry experts have welcomed this deletion claiming that this would allow FDI in Indian companies operating in SBRT sector which were incapable of manufacturing their products in-house. However, the full impact of the deletion of the wordings of the 70-30 Rule remains unclear.

One could argue that deleting the wordings of the 70-30 Rule from the 2017 FDI Policy, effectively permits an Indian company that out-sources more than 30% of its production to contract manufacturers, to avail 100 percent FDI via the automatic route and sell its products manufactured in India through wholesale and/or retail, including through e-commerce without any governmental approval or compliance with the SBRT FDI Norms.

However, whether this argument can be sustained or not would depend on the definition of the term manufacturing as provided in the 2017 FDI Policy. The 2017 FDI Policy has defined manufacture, with its grammatical variations, *"as a change in a non-living physical object, resulting in transformation of the object into a new and distinct article having a different name, character and use, or bringing into existence of a new and distinct thing with a different chemical composition or integral structure"*. This definition has been reproduced verbatim from Section 2(29BA) of the Income Tax Act, 1961.

The Judicial Test of Manufacturing

In the leading case of *Union of India v. Cibatul Limited*[1] (the "Cibatul Case"), the Supreme Court interpreted the term manufacture in a brand owner-contract manufacturing structure, *albeit* from the perspective of the Central Excise Act, 1944. In this case, certain resins were to be manufactured by a contract manufacturing company in accordance with a programme that was jointly drawn up by the contract manufacturing company and the brand owner. The brand owner also authorised the contract manufacturing company to affix its trademarks on the manufactured products that were to be sold to the brand owner. As per the existing arrangement, subsequent to inspection and approval by the brand owner, the goods so approved would be sold by the contract manufacturing company to the brand owner. Here, the Supreme Court had to examine the question of whether the goods were being manufactured by the contract manufacturing company on its own account or on behalf of the brand owner.

Finally, the Supreme Court held the contract manufacturing company to be the manufacturer even though the trademark was not owned by it. It observed that the mere supply of raw material to the job workers would not make the brand owner the manufacturer of the goods even if the goods were produced under its brand-name and under its quality control standards so long as the contact manufacturing company's relation with the brand owner was on a 'principal to principal' basis. The underlying rationale was that the contract manufacturing company manufactured the goods on its own account on a principal-to-principal basis and not on behalf of the brand owner. In other words, the risk of manufacturing

[1] 1985 (22) ELT 302 (SC).

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vests with the contract manufacturing company and not the brand owner.

Hence, going by the ratio of the *Cibatul* case, it logically follows that a brand owner may not be considered as a manufacturer under the 2017 FDI Policy even if it procures the raw materials and retains the title over the same, exercises quality control over the manufacturing process, causes its trademark to be put on the goods or pays the labour charges to the contract manufacturer, if its relationship with the contract manufacturer is on a principal-to-principal basis. However, if the brand owner were to assume the entire risk in respect of manufacturing the goods and did not reserve the right to reject the goods for not conforming to the brand owner's given specifications, then it would indeed be considered as a manufacturer as per the *Cibatul* case. It is necessary that the brand owner must bear all risks, proprietary or otherwise, associated with the manufacturing process so that it is a situation where the contract manufacturer merely carries out the manufacturing process on behalf of the brand owner.

<u>The Standard Commercial Model of Contract Manufacturing</u>

The principle of law laid down in *Cibatul* case was in the context of a tax legislation but whether it will be applicable to interpret the definition of manufacturing under the 2017 FDI Policy can not be commented with certainty. The terms of each contract of manufacturing must be analysed independently.

A review of the terms of various manufacturing contracts across industry sectors including textiles, electronics, food processing, pharmaceuticals reveals that the terms are largely similar. As a matter of commercial practice, in agreements for contract manufacturing, the manufacturing company usually assumes all the risk associated with the manufacturing process such as the risk of rejection of defective goods manufactured, health and safety risk of workmen, environmental risks, legal and regulatory non-compliance risk, product liability risk, etc. The outsourcing company although usually provides for guidelines and standards of manufacturing, it still generally retains the right to inspect and reject the goods manufactured.

Since the risk associated with the manufacturing process is assumed by the manufacturing company and the right to reject is available with the outsourcing company, going by the judicial test of manufacturing laid down in the *Cibatul* case, it appears that in most cases of contract manufacturing the outsourcing company shall not be considered as the manufacturer.

<u>Relaxation for Manufacturers to Manufacture Indian Brands</u>

The wordings of the 70-30 Rule in the 2016 FDI Policy stated that in order to qualify as an 'Indian Manufacturer', an investee manufacturing company must also be the owner of the Indian brand. Therefore, for illustration, if an Italian company owning an Italian garment brand intended to set up a subsidiary company in India for 100 percent in-house manufacturing and selling of garments under the Italian brand name in retail brick and mortar stores situated in India, it would not be considered as 'Indian Manufacturer' since it did not own an Indian brand. Therefore, an unintended consequence of the existence of the 70-30 Rule wordings in the 2016 FDI Policy was that such an Indian subsidiary of an Italian company had to comply with SBRT FDI Norms despite the fact it was manufacturing in India in full compliance with the 70-30 Rule.

However, with the deletion of the 70-30 Rule wordings from the 2017 FDI Policy, foreign

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companies will now be allowed to manufacture their foreign branded products in India, perhaps through a subsidiary, and subsequently sell them through wholesale, retail or e-commerce without government approval.

Conclusion

FDI in the retail sector has always remained a controversial issue ever since the government started introducing reforms to liberalise this sector in 2006. While the recent changes introduced by the government under the 2017 FDI Policy are welcome, there are still ambiguities in connection with the SBRT FDI Norms as to what are the parameters for determining whether a product is 'state of the art' and possesses 'cutting edge' technology and also whether the SBRT FDI norms will be applicable to Indian companies who engage in SBRT of products manufactured by them through contract manufacturing.

Undoubtedly, the biggest gainer from the 2017 FDI Policy will be the manufacturing sector if one accepts the view that companies that outsource their production to 'contract manufacturers' would also be considered to be operating in manufacturing sector and therefore implying that the SBRT FDI norms will not be applicable to such companies.

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Restriction on number of layers on companies

By **Pulkit Chaturvedi**

The Ministry of Corporate Affairs (MCA) *vide* Notification S.O. 3086(E), dated September 20, 2017 notified proviso to Section 2(87) of Companies Act, 2013 (Act). The notified clause provides for the definition of '*Subsidiary company*' and specifies that such classes of holding companies, as prescribed, shall not have layers of subsidiaries beyond the numbers as may be specified. In furtherance to the notification bringing in force the said proviso, the MCA *vide* Notification G.S.R. 1176 (E) (Notification) notified the Companies (Restriction on number of layers) Rules, 2017 (Rules).

The Notification provides for restriction on layers of companies and the MCA has notified that any company, post commencement of these Rules, shall not have more than two layers of subsidiaries. However, it has been clarified that this rule will not affect a company acquiring another company incorporated outside India with subsidiaries beyond two layers as per the laws of those countries. For the purpose of calculating the number of layers under this rule, it has been specified that one layer consisting of one or more wholly owned subsidiaries shall not be taken into account. This Notification seems to have a negative connotation on the workings of the corporates as it has stated that no company can have more than two layers of subsidiaries. Thus, even if such subsidiaries are formed for legitimate reasons such as genuine ease of doing business, operational flexibility etc., they shall not be allowed.

Section 186 of the Act also provides a similar restriction wherein a company is restricted to make investment through more than two layers of investment companies. The Report of the Companies Law Committee[2] (CLC Report) states the reasoning for adding this provision. It states that this was included to address practices of

[2] Report of the Companies Law Committee, February2017, Ministry of Corporate Affairs, Government of India.

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creating subsidiaries aimed at making it difficult to trace the source of funds and their ultimate use, and to reduce the usage of multiple layers of structuring for siphoning off funds.

The JJ Irani Committee Report (JJ Irani Report) on Company Law, which formed the basis for drafting the Act, had recommended that the Act should not impose severe restrictions on corporate structuring as these prescriptions would be disadvantageous to Indian companies *vis-à-vis* their international counterparts. JJ Irani Report, while acknowledging the concerns relating to lack of transparency, noted that these concerns can be curbed through disclosures accompanied by mandatory consolidation of financial statements and a proper implementation of these disclosures shall be sufficient. It further noted that siphoning off of funds could take place through other routes, and therefore imposing a blanket restriction on the number of layer of subsidiaries will not be the best way to deal with such concerns. Thus it had expressed a view that there should not be any restriction to a company having any number of subsidiaries, or to such subsidiaries having further subsidiaries. The Parliamentary Standing Committee, that was created to review the Companies Bill, 2012, had stated in its report that various stakeholders had represented that imposing restrictions on layers could be construed as restrictive for conduct of businesses. Therefore, The CLC Report had recommending omitting the proviso by noting that though the proviso to section 2(87) had not been notified, it was likely to have a substantial bearing on the functioning, structuring and the ability of companies to raise funds when so notified.

CLC Report in relation to the layering restrictions on investment companies under Section 186(1) stated that such restriction will become too obtrusive and impractical in the modern business world while noting the regulatory concerns arising out of earlier scams. It acknowledged that there might be several legitimate business justifications for use of a multi layered structure and such a restriction would hamper the ability of a company to structure its business. CLC Report provided that sufficient safeguards have been built into the oversight mechanism of SEBI and stock exchanges, and thus this restriction should be omitted.

Interestingly, the Central Government in Companies Amendment Bill, 2016 (Bill) had proposed to omit this restriction in Section 186 as well as the proviso in Section 2(87), altogether.[3] However, during the course of debates in the Lok Sabha while considering the Bill, a number of parties raised objections for removal of these restrictions. It was stated that removal of such a restriction will aid in creating shell companies which will in a way promote the conversion of black money. Thus, the Bill as passed by Lok Sabha on July 27, 2017 rejected these amendments.

The Rules however specify that these provisions shall not apply to the following companies:

1. Banking Company;
2. A Non-Banking Financial Company which is registered with the Reserve Bank of India and is considered as systemically important by them. i.e. NBFC whose asset size is of Rs. 500 Crore or more;
3. Insurance Company; and
4. Government Company

The Rules further provide that every company which has more than two layers of subsidiaries, existing on or before September 20, 2017 should intimate the registrar of companies, in the notified form, disclosing the details of such companies within 150 days from the commencement of these rules. It also specifies that such companies shall not have any additional layer of subsidiaries

[3] Clause 60, Companies Amendment Bill, 2016 as tabled in Lok Sabha.

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over and above the layers existing and in case it removes one of the layers of the companies, it shall maintain such reduced number of layers or two, whichever is more. If a company is found contravening the provisions of these Rules, it shall be liable to a fine which can extend up to Rs. 10,000 (ten thousand rupees) and if the contravention is a continuing one, a further fine up to Rs. 1000 (one thousand rupees) shall be levied every day till the time the contravention continues.

From this Notification, it can be inferred that the Central Government has changed its stance with regards to removal of such restrictions as it had put forward in the Bill and is now of the opinion that such a restriction is required. Even though the CLC Report as well as the JJ Irani Report had recommended that such a restriction should be removed as it will create hindrances in the legitimate functioning of the companies, the Central Government has decided to disregard such recommendations. It will be interesting to see how the Notification impacts the functioning of companies with a genuine need to create subsidiaries because of the large involvement of the resources as well as diverse areas of practice. It can only be hoped that Companies Amendment Bill, 2016, when it is passed by the Rajya Sabha, considers the concerns of the various stakeholders and omits these restrictions, as was proposed previously.

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Notifications

Companies (Registered Valuers and Valuation) Rules, 2017: For a valuation exercise of any property (e.g. shares, debentures, goodwill or any other assets), or in respect of net worth of a company, Section 247 of the Companies Act, 2013 (CA 2013) mandates such valuation to be undertaken by registered valuers (persons having such qualifications and experience and registered as a valuer in such manner, on such terms and conditions as may be prescribed). With effect from October 18, 2017, the provisions of Section 247 read with the Companies (Registered Valuers and Valuation) Rules, 2017 ('Rules'), have come into force.[1]

Pursuant to enforcement of Section 247 and the Rules, MCA recognized that a difficulty had arisen in view of the fact that numerous different organisations dealing with distinct group of assets (such as land and building, machinery and equipment) have separate set of valuers for valuation. The MCA noted unless these different organisations are recognised, it would be difficult to ensure the required level of regulation for valuers and further, it is necessary to recognise the varying standards of internal procedures and conduct practiced in these organisations to improve the standards in valuations, in order to register the valuers under Section 247. With a view to provide clarity, MCA has amended Section 247 to include a reference to an organisation to which a valuer may belong[2].

With effect from October 23, 2017, the Central Government has delegated the powers and

[1] Notification No.S.O.3393 (E) dated October 18, 2017 by Ministry of Corporate Affairs

[2] Companies (Removal of Difficulties) Second Order, 2017 vide Notification No.S.0. 3400 (E) dated October 23, 2017 by Ministry of Corporate Affairs

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functions vested in it under Section 247 such as registration, recognition and ancillary matters related to valuers, to the Insolvency and Bankruptcy Board of India (IBBI)[3].

Henceforth, an individual/partnership/company applicant is required to obtain a certificate of registration. However, entities which are currently carrying out valuation activities have been given a transition period until March 31, 2018, during which they may continue to render valuation services without obtaining a certificate of registration. Under the Rules, a Committee comprised of members including from the MCA, IBBI, registered valuers organizations and industry stakeholders, would be constituted to advise on valuation matters and recommend valuation standards to be adopted. Further, the Rules also lay down a Model Code of Conduct for registered valuers.

Resolution plans under Insolvency and Bankruptcy Code – Deemed approval of shareholders: Section 30 and 31 of the Insolvency and Bankruptcy Board of India ('IBC') provide a detailed procedure for submission of an insolvency resolution plan by the resolution professional to its approval by the National Company Law Tribunal ('NCLT'), respectively.

Under Section 30(2)(e) of the Code, the resolution professional is required to examine the resolution plan received to ensure such plan does not contravene any other provisions of law in force. In view of this stipulation, the MCA has issued a clarification on October 25, 2017[4], clarifying that the approval of shareholders/members of a corporate debtor for any actions contained in the resolution plan for its implementation (which would normally require the specific approval of shareholders/members to be obtained under CA 2013 or any other law if the resolution plan of the company was not being considered under IBC), shall be deemed to have been given on approval of such resolution plan by the NCLT.

Therefore once the resolution plan has been approved by NCLT, then any action under such resolution plan which would otherwise have required shareholders' approval to be obtained under CA 2013 or any other law, can be implemented without obtaining shareholders' approval, as such approval shall be deemed to have been given.

Investor Education and Protection Fund Authority (Accounting, Audit, Transfer and Refund) Second Amendment Rules, 2017: Under the Companies Act, 2013 ('CA 2013'), any money transferred by a company to its Unpaid Dividend Account, which remains unpaid or unclaimed for a period of seven years from the date of such transfer, is required to be transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund ('Fund')[5]. Further, all shares in respect of which dividend has not been paid or claimed for seven consecutive years or more, are also required to be transferred by the company in the name of the Fund[6].

The Ministry of Corporate Affairs ('MCA') has *vide* its Notification dated October 13, 2017, notified the 'Investor Education and Protection Fund Authority (Accounting, Audit, Transfer and Refund) Second Amendment Rules, 2017 ('Amendment'). Some key provisions are as follows:

(i) In case the period of seven years under Section 124(5) has been completed/being completed during the period from 7th September, 2016 to 31st October, 2017,

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[3] Notification dated October 23, 2017 by Ministry of Corporate Affairs

[4] General Circular No.IBC/01/2017 dated October 25, 2017 by Ministry of Corporate Affairs

[5] Section 124(5), Companies Act, 2013

[6] Section 124(6), Companies Act, 2013

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the due date of transfer of such shares shall be deemed to be 31st October, 2017.

(ii) Transfer of shares by companies to the Investor Education and Protection Fund (Fund) shall be deemed to be transmission of shares and the procedure to be followed for transmission of shares is to be followed by the companies while transferring shares to the Fund.

(iii) The Investor Education and Protection Fund Authority ('IEPF Authority') is to furnish a report to the Central Government as and when non-compliance of these Rules by companies comes to its knowledge.

(iv) Every company which has deposited amounts to the Fund is required to nominate a Nodal Officer for coordination with IEPF Authority and to communicate contact details of such Nodal Officer to the IEPF Authority, within fifteen days from date of publication of these Rules, as well as is required to display the contact details of the Nodal Officer on its website.

(v) For the purposes of effecting transfer of shares by the Company in the name of IEPF [i.e. transfer of shares in respect of which dividend has not been paid or claimed for seven consecutive years or more under Section 124(6) of CA 2013] - where such shares are held in physical form- the Company Secretary or the person authorised by the Board is required to make an application on behalf of the concerned shareholder to the company, for issue of a **new** share certificate. Prior to the amendment, the sub-rule had stipulated such application to be made for issue of a **duplicate** share certificate. On receipt of such application, a **new** share certificate for each such shareholder shall be issued.

Pursuant to the amendment, MCA also issued a Circular dated October 16, 2017 ('Circular'), providing the details of the demat accounts opened by the IEPF Authority. MCA has clarified that any cash benefit accruing on account of shares transferred to IEPF such as dividend, proceeds realised on account of delisting of equity, amount entitled on behalf of security holder if company is being wound up[7], is required to be transferred by companies to designated bank accounts opened by the IEPF Authority which have been linked to demat accounts specified in the Circular.

Master direction on issuance and operation of pre-paid payment instruments: The Reserve Bank of India has announced new norms for issuance and operation of Prepaid Payment Instruments (PPIs), thereby removing the temporary suspension that had been imposed on submission of new applications. With effect from October 11, 2017, new applicants are required to fulfil eligibility criteria specified in these new norms. Some key changes (in comparison to the norms previously applicable) concerning the application and eligibility process for prospective applicants are as follows:

(i) Minimum Net-worth: A non-bank applicant is required to have a minimum positive net-worth of Rs.5 Cr as per the latest audited balance sheet at the time of submitting its application. The application shall be processed by RBI based on this net-worth which is to be maintained at all times. By the end of the third financial year from the date of receiving final authorisation, the entity is required to achieve a minimum positive net-worth of Rs.15 Cr, which is to be maintained at all times. Illustratively, if an entity is issued a

[7] as per Rule 6, sub-rule (10), (11) and (12) of Investor Education and Protection Fund Authority (Accounting, Audit, Transfer and Refund) Rules, 2016

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final authorisation on March 1, 2018, then it is required to achieve a minimum positive net-worth of Rs.15 Cr for the financial position as on March 31, 2020. A newly incorporated entity which may not have an audited statement of financial accounts may be required to submit a certificate from their Chartered Accountants regarding the current net worth and documents in support of the capital infusion and funds available to undertake the business.

(ii) Fit and proper status: Before granting authorization, RBI may check the applicant's 'fit and proper' status by obtaining inputs from other regulators and government departments. Additionally, RBI shall also apply checks on certain aspects like customer service and technical requirements, before granting an in-principle approval.

(iii) Two-step authorization process: In the first instance, RBI will issue only an 'in-principle' approval valid for six months. During this six-month period, the applicant is required to submit a 'System Audit Report' to RBI, failing which the in-principle approval would lapse automatically. An applicant may seek a one-time extension for a maximum of six months. However, RBI reserves the right to deny such an extension. Subsequent to grant of in-principle approval, if any adverse features come to the notice of RBI, RBI may impose additional conditions and if warranted, the in-principle approval may be withdrawn.

(iv) Commencement of Business: Entities granted final authorization are required to commence business within six months from the grant of Certificate of Authorization, failing which the authorization would lapse automatically. An entity may seek a one-time extension for a maximum of six months, on submission of valid reasons. However, RBI reserves the right to deny such an extension.

(v) Intimation of material changes: Issuers are required to inform RBI of any takeover or acquisition of control or any change in the management, within 15 days of such developments. Additionally, any major changes proposed to the payment system (e.g. changes to product features, structure or operation of the payment system) are also required to be communicated to RBI.

(vi) PPI issuer is required to ensure there is no co-mingling of funds originating from any other activity that the Issuer may be undertaking such as intermediary for payment aggregation, payment gateway facility etc.

(vii) A comprehensive 'Security, Fraud prevention and Risk Management' framework is required to be put in place. PPI Issuers are required to immediately report cyber security incidents/ breaches to RBI.

(viii) A 'publicly disclosed customer grievance redressal' framework is required to be put in place.

Peer to Peer Lending Platforms - Non-Banking Financial Company: With the emergence of online lending platforms, RBI had recently notified in August 2017, that a non-banking institution carrying on the business of a peer-to-peer lending platform would be designated as an NBFC. "Peer to Peer Lending Platform" refers to an intermediary providing the services of loan facilitation, usually *via* an online marketplace/platform. On October 04, 2017, RBI laid down the regulatory framework for registration and operation of such NBFC-Peer to

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Peer Lending Platforms (NBFC-P2P), which are applicable to both prospective and existing NBFC-P2Ps. Existing entities undertaking the business of P2P are required to apply for registration as an NBFC-P2P, within 3 months from the issuance of these norms. Some of the key provisions concerning the application and eligibility process are as follows:

(i) Nature of Entity: No non-banking institution other than a company shall undertake the business of P2P.

(ii) Net-Owned Fund: Every company seeking registration as an NBFC-P2P shall have a net owned fund of not less than Rs. 20 million or such higher amount as RBI may specify

(iii) Fit and proper criteria: NBFC-P2Ps are advised to ensure that before any director is appointed to the Board, due diligence is undertaken to determine suitability and 'fit and proper' status at the time of appointment, as well as renewal of appointment.

(iv) Two-step approval process: In the first instance, RBI will issue only an 'in-principle' approval valid for twelve months. During this twelve-month period, the applicant is required to put in place the technology platform, enter into legal documentations required and report position of compliance with the terms of grant of in-principle approval. However, RBI reserves the right to deny such an extension. RBI may, after being satisfied that the entity is ready to commence operations, grant a Certificate of Registration as an NBFC–P2P.

(v) Public Notice for Change in Control: Prior public notice of at least 30 days is required to be given by the NBFC-P2P (as well as the parties concerned) before effecting any transfer of ownership or transfer of control, whether with or without sale of shares - indicating the intention to sell or transfer ownership/control, the particulars of transferee and the reasons for such sale or transfer of ownership/ control.

(vi) Prior Approval of RBI: Prior RBI permission shall be required to be sought in various instances such as for (a) any allotment of shares which will take the aggregate holding of an individual or group to 26% or more of paid up capital of NBFC-P2P; (b) any takeover or acquisition of control which may or may not result in change of management; (c) change in more than 30% of the Directors, excluding independent Directors; (d) any change in shareholding that will give the acquirer a right to nominate a Director.

(vii) A publicly disclosed grievance redressal policy is required to be put in place.

(viii) NBFC-P2P is required to make reasonable arrangements to ensure that loan agreements facilitated on the platform will continue to be managed and administered by a third party in accordance with the contract terms, if such NBFC-P2P ceases to carry on P2P activity.

Simplified hedging procedures - Foreign Exchange Management (Foreign Exchange Derivative Contracts) (Second Amendment) Regulations, 2017: RBI has amended the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000, *vide* its Notification dated October 24, 2017[8], as per which resident entities with foreign currency exposures and non-resident entities with rupee exposures, other than individuals, may hedge underlying exchange rate risk arising out of transactions permitted under Foreign Exchange Management Act, 1999 and rules

[8] Notification No. GSR 1324(E) dated October 24, 2017, by Reserve Bank of India

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framed thereunder, on such simplified terms and conditions as may be issued by RBI from time to time.

Report submitted by Committee on Corporate Governance: With a view to enhance the corporate governance standards of listed entities in India, SEBI had constituted a Committee on Corporate Governance in June 2017, comprised of officials from the government, industry, professional bodies, stock exchanges, academicians, lawyers, etc. The Committee released its Report on October 05, 2017, inviting public comments until November 04, 2017.

This Report sets out the recommendations of the Committee, the rationale as well as expected timelines for implementation of such recommendations. The Report suggests certain amendments to existing provisions as well as proposes certain new provisions for effective implementation of the recommendations. The recommendations pertain to various corporate governance aspects such as composition and role of the Board of directors, role of independent directors and various Board Committees, related party transactions, accounting and audit issues and disclosures to be made, to name a few.

Disclosures by listed entities of defaults on payment of interest/repayment of principal amount on loans from banks/financial institutions, debt securities, etc.: The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("SEBI LODR Regulations") currently require disclosure of material events / information by listed entities to stock exchanges. Specific disclosures are required for delay / default in payment of interest / principal on debt securities including listed Non-Convertible Debentures, listed Non-Convertible Redeemable Preference Shares, Foreign Currency Convertible Bonds etc.

However, similar disclosures are presently not stipulated with respect to loans from banks and financial institutions in light of many banks in India being crippled with Non-Performing Assets (NPAs). To rectify this gap in availability of information to investors, SEBI had previously issued a Circular dated August 04, 2017 ('August Circular'), applicable to listed entities which have listed specified securities, non-convertible debt securities or non-convertible and redeemable preference shares.

The August Circular was proposed to have come into effect from October 01, 2017, and proposed that when such listed entity defaulted in payment of interest / instalments on debt securities, Foreign Currency Convertible Bonds, loans from banks and financial institutions, External Commercial Borrowings etc., such entity would be required to disclose such default within one working day from the date of default, at the first instance of default. Further, SEBI had also proposed the format to be adopted by entities for making such disclosure.

However shortly before the August Circular was scheduled to take effect on Oct 01, 2017, SEBI issued a Press Release on September 29, 2017[9], deferring the implementation of these proposed measures until further notice.

Alternative Investment Funds - Change in reporting norms: In June 2017, SEBI had permitted Category III[10] Alternative Investment Funds (AIFs) to participate in the commodity derivatives market, subject to certain conditions such as, (i) Category III AIFs are not to invest more than 10% of the investable funds in one underlying commodity; (ii) Category III AIFs shall

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[9] PR No. 59/2017 dated September 29, 2017 by Securities and Exchange Board of India

[10] As per Regulation 3(4)(c) of SEBI (Alternative Investment Funds) Regulations, 2012, Category III AIFs are AIFs that employ diverse or complex trading strategies and which may employ leverage including through investment in listed or unlisted derivatives.

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be subject to reporting requirements as may be specified by SEBI. Pursuant to this, SEBI has notified[11] revised reporting formats for Category III AIFs that capture information pertaining to investment made by Category III AIFs in commodity derivatives, to be submitted on monthly/quarterly basis for the period ended September 30, 2017 onwards.

Ratio Decidendi

‘Front running activities’ under SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 include ‘non-intermediary front-running’

Brief Overview

In a liberal interpretation given to the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 (“FUTP 2003”), the Supreme Court has held that ‘non-intermediary front-running’, that is front running activities by private individuals, will also be included and prohibited within the ambit of FUTP 2003.

Facts

The previous version of the FUTP Regulations issued in 1995 specifically prohibited front running activities by any ‘person’. When the earlier version of the FUTP Regulations was replaced by FUTP 2003, Regulation 4(2)(q) continued to prohibit front running activities, though this prohibition extended only to ‘intermediaries’. This gave rise to the issue whether the FUTP 2003 permits or prohibits front running activities by ‘non-intermediaries’.

The batch of appeals filed to the Supreme Court were against orders of the Securities Appellate Tribunal (“SAT”) where the SAT had given differing opinions on the prohibition of front running activities by non-intermediaries. These appeals contained questions of legality of front running activities not by traders (who qualify as intermediaries), but by their portfolio managers, relatives and spouses (acting on the instructions and leads of the traders).

Contentions

The Appellants contended that various sub-clauses of Regulation 4 of FUTP 2003 (*Prohibition of manipulative, fraudulent and unfair trade practices*), which include Regulation 4(2)(q) prohibiting front running activities by intermediaries, expressly make themselves applicable only to the case of intermediaries and not to individual buyers or sellers. The rest of the sub-clauses being part of the scheme which seeks to regulate the conduct of intermediaries, will be deemed to pertain to activities undertaken by intermediaries, thereby making whole of Regulation 4 inapplicable to the Appellants.

Observations and Judgment

The Supreme Court extensively analysed the nature and definition of ‘front-running’. The court gave a 3-part definition to ‘front running’, stating that front running comprises of three forms of conduct – “tippee trading”, “self-front running” and “trading ahead”. While the third category has been explicitly recognised under Regulation 4(2)(q), the Court concerned itself with the first category (the nature of activities in the civil appeal), that is, “tippee trading” – trading by third

[11] Securities and Exchange Board of India Notification No. SEBI/HO/IMD/DF1/CIR/P/2017/110, dated September 29, 2017

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parties who are tipped on an impending block trade.

Highlighting that the object and purpose of the FUPT 2003 is to curb market manipulations and prevent market abuse, the Court held that as a matter of principle, while interpreting FUTP 2003, the Court must weigh against an interpretation which will protect unjust claims over just, fraud over legality and expediency over principle.

The Court interpreted the inclusive definitions of the terms "dealing in securities" and "fraud" contained in the Regulations and held that *prima facie*, these definitions are broad in nature and are meant to be "catch all provisions". The Court held that Regulation 3 which prohibits a person from committing fraud while dealing in securities describes the width of power vested with SEBI to regulate the security market and the words of the provision are of wide amplitude to take within its sweep the inducement to bring about inequitable results which are in question. Further, Regulation 4(1), which supplements Regulation 3 prohibits any "person" to indulge in fraudulent or unfair trade practices in securities.

Holding that non-intermediary front running may be brought under these catch-all prohibition of Regulations 3 and 4(1), being fraudulent or unfair trade practices, the Court stated that a pigeon-hole approach in such cases should not be applied. Merely because a provision, namely Regulation 4(2)(q), does not regulate non-intermediaries, fraudulent or unfair trade practices in securities will not be outside the ambit of FUTP 2003.

Analysis

The Supreme Court adopted a purposive and liberal approach to interpreting FUTP 2003 and emphasized that the object and aim of the Regulations is to safeguard the investing public and honest businessmen. Adopting a strict interpretation would instead defeat the purpose of the legislation, as well as allow tippee's fraudulent practices to continue unchecked. [*Securities and Exchange Board of India* v. *Kanaiyalal Baldevbhai Patel* – Judgment dated 20-9-2017 in Civil Appeal No. 2595 of 2013 (with connected appeals), Supreme Court]

Timelines under Insolvency and Bankruptcy Code, 2016 for ascertaining existence of default and admitting or rejecting application, as well as for rectifying defects, are directory, and not mandatory

Brief Overview

The question arising on appeal from an Order of the National Company Law Appellate Tribunal ("NCLAT") was whether the time period of 7 days for rectification of defects by the applicant for initiation of insolvency resolution process under the Insolvency and Bankruptcy Code, 2016 ("IBC") is mandatory or directory, the Supreme Court while holding that such time limit is directory, also confirmed the decision of the NCLAT which held that the time of 14 days within which the adjudicating authority is required to admit or reject the petition, is also directory (and not mandatory).

Facts

The Appellant, an operational creditor of the Respondent, had served a demand notice on the Respondent calling upon it to pay outstanding dues. As the dues were not paid, the Appellant filed an application for initiation of corporate insolvency resolution process under Section 9 of the IBC. Upon filing the application, the registry of the adjudicating authority pointed out some procedural defects and granted the Appellant time to clear defects. Though the procedural defects were cleared, they were only done so after the allowed time of 7 days under the IBC. The Respondent raised objections on maintainability, and the insolvency petition of the

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Respondent was rejected as defective and incomplete.

On an appeal to the NCLAT, the NCLAT confirmed that Appellant's case was fit to be rejected as incomplete and as the defects were not removed within the mandatory 7-day time. In interpreting the timelines under the IBC, the NCLAT held that the 14-day time prescribed under IBC for admitting/rejecting an insolvency petition is directory, and not mandatory, but the 7-day timeframe for curing defects is mandatory.

Observations and Judgment

The Supreme Court agreed with the decision of the NCLAT where it held that the 14-day time period prescribed for the adjudicating authority to admit or reject a petition is directory in nature, as the relevant section is procedural in nature and a tool of aid in expeditious dispensation of justice (*on the principle that procedure should not be a restraint in the administration of justice*).

However, as the NCLAT judgment gave no valid reason or discussion on why the 7-day time limit should be held to be mandatory, even though it is also a rule of procedure and stands on the same footing as the 14-day timeframe, the Supreme Court held that that even this 7-day time for removing defects should be held to be directory.

In coming to this conclusion, the Court held that there may be cases where weighty, valid and justifiable reasons exist for not able to remove the defects within 7 days. However, if the 7-day time is to be made mandatory, it would lead to rejection of the entire case without even hearing the case on merits. Not only would this be rejection of an substantive application by way of an administrative order, but would also be travesty of justice. In fact, if the application is rejected without even going into merits, nothing bars the applicant to file fresh application, complete in all aspects, which would then have to be heard. Hence, no purpose is served by treating the aforesaid 7-day timeframe as mandatory.

The Court, however, did acknowledge that a balanced approach is needed, especially keeping in mind that the IBC was enacted to ensure timely justice. There may be litigants who show laxity by not removing defects or file frivolous applications with oblique motives which remain pending, and to deal with all such situations, in case the objections/defects are not removed within seven days, the applicant while re-filing the application after removing defects would have to file an application in writing showing sufficient case as to why the applicant could not remove defects within 7 days. When the application comes up for hearing, it would be for the adjudicating authority to decide as to whether sufficient cause is shown. Only then will the insolvency application be entertained.

Analysis

While the Supreme Court has laid great emphasis on the principle that procedural law should not ordinarily be construed as mandatory and that it is always subservient to and is in aid of justice, the Court has, *albeit* impliedly, added an additional layer in the process of filing an insolvency application under IBC. In case the defects are not removed within the prescribed period of 7 days, the applicant will file an additional application explaining the reasons for delay. This application will be heard to the satisfaction of the adjudicating authority. By adding another step in the insolvency process, the entire scheme of time-bound insolvency process under the IBC, will undoubtedly be stretched out. [*Surendra Trading Company* v. *Juggilal Kamlapat Jute Mills Company Limited.* – Judgment dated 19-9-2017 in Civil Appeal No. 8400 of 2017, Supreme Court]

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"Dispute" under Insolvency and Bankruptcy Code, 2016 must consist of a "real dispute" raising a plausible contention requiring further investigation rather than a patently feeble legal argument

Brief Overview

The Supreme Court in its judgment decoded the meaning of the term "dispute" and "existence of a dispute" and held that for rejecting an application filed by an operational creditor for insolvency resolution, the existence of a "real" dispute is necessary, i.e., real as opposed to frivolous and/or illusory. The adjudicating authority is only required to see that a dispute truly exists in fact and is not spurious, hypothetical, plainly frivolous or vexatious. The adjudicating authority is not required to be satisfied whether the defence is likely to succeed or not, or examine the merits.

Facts

The Respondent, as an operational creditor of the Appellant, filed an insolvency application against the Appellant in the National Company Law Tribunal ("NCLT") (the adjudicating authority) under provisions of the Insolvency and Bankruptcy Code, 2016 ("IBC"). The application of the Respondent was rejected by the NCLT due to pendency of a "dispute" between the Respondent and the Appellant. The dispute related to the Appellant withholding payment of the Respondent for breach of terms of a non-disclosure agreement (NDA).

The National Company Law Appellate Tribunal ("NCLAT") reversed the order of the NCLT and allowed the insolvency application of the Respondent stating that the "dispute", pleaded as a defence by the Appellant, was vague, got up and motivated to evade the liability.

This brought the question before the Supreme Court on the extent and interpretation of the term "dispute" and "existence of a dispute" existing in Section 8 of the IBC.

Contentions

The Appellant argued that under the IBC, the definition of "dispute" is an inclusive definition and the original draft Bill of the IBC not only had a "means" definition instead of and inclusive one, but also the words "bona fide" were included before the words "suit or arbitral proceedings". This is missing in the present IBC, which shows that the extent of the definition of "dispute" has changed. The moment there is existence of a dispute, meaning thereby that there is a real dispute to be tried, and not a sham, frivolous or vexatious dispute, the NCLT is bound to dismiss the application. The NCLT should not concern itself with the merits of the dispute.

The Respondent, on the other hand, argued that the expression "dispute" under the IBC covers only three things, namely, existence of the amount of debt, quality of goods or services or breach of a representation or warranty and since what was sought to be brought as a defence was that the breach of NDA, it would not come within the definition of "dispute". At best, the breach of the NDA is a claim for unliquidated damages which does not become crystallised until legal proceedings are filed. Therefore, there is no real dispute.

Observations and Judgment

The Supreme Court analysed in detail the legislative history and background of how the IBC was brought in force. Under the Insolvency and Bankruptcy Bill, 2015, the definition of "dispute" was a "means" definition, thereby implying an exhaustive definition. Further, the definition in the bill contained the words "*means a bona fide suit or arbitration proceeding relating…*". However, under the IBC, the definition of dispute has been expanded to an inclusive definition, and the test of the litigation being *bona fide* has been removed.

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To understand the extent and meaning of the term dispute, the Court placed reliance on decisions of the Australian High Court and Chancery Division in the UK which discussed the expression "existence of a dispute" and "genuine dispute". By relying on these decisions, the Court held that it is important that the existence of the dispute and/or the suit or arbitration proceedings must be pre-existing – i.e. it must exist before the receipt of the demand notice. Further, the Court held that all that the NCLT has to examine (when an insolvency application is made) is whether there is a plausible contention which requires further investigation and that the "dispute" is not a patently feeble legal argument or an assertion of fact unsupported by evidence. It is important to separate the grain from the chaff and to reject a spurious defence which is mere bluster. However, in doing so, the NCLT does not need to be satisfied that the defence is likely to succeed. The NCLT does not at this stage have to examine the merits of the dispute.

In holding this, the Supreme Court concluded that the NCLT was correct in dismissing the insolvency application of the Respondent in the first instance as a real dispute as to payment between the parties exists in the present case. The argument of the Respondent that the dispute only concerns the NDA, was rejected.

Analysis

Even though this is the first decision of the Supreme Court analysing in-depth the meaning of the terms "dispute" and "existence of a dispute", it is pertinent to note that the Court has only prescribed broad guidelines and principles for the NCLT to determine whether the dispute is genuine or real or merely illusory. As the NCLT does not have to examine the merits of the dispute or whether the defence is likely to succeed, the criteria to decide whether the dispute is real or a patently feeble legal argument remains an objective one, and will depend on the satisfaction and understanding each NCLT judge. This may lead to inconsistencies, which may lead to more disputes. [*Mobilox Innovations Private Limited* v. *Kirusa Software Private Limited* – Judgment dated 21-9-2017 in Civil Appeal No. 9405 of 2017, Supreme Court]

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